

Quarterly Fund Commentary

Quarter 2 2020

Morningstar Investment Management South Africa

July 2020



The first six months of 2020 can only be described as a tale of two halves. Following the record falls in global equity markets across the globe in the first quarter amidst concerns around the economic impact of the spread of the Covid-19 pandemic, the second quarter saw one of the fastest recoveries on record. This came despite concerns around a second wave of infections in some developed markets, particularly in the US, and continued growth in daily infections in key emerging economies, including South Africa. Market participants continued to react positively to the unprecedented levels of fiscal stimulus announced by major central banks and governments across the globe.

South African equities benefitted from the dramatic shift in investor sentiment, generating strong returns in the quarter following a difficult start to the year. Returns from the local equity market were largely driven by Resources (+41%), however, both Industrials (+17%) and Financials (+13%) also generated decent returns. Gold and platinum counters were amongst the most significant beneficiaries of the current market environment, the former benefiting from the economic uncertainty related to the global pandemic and the latter from continued favourable supply/demand dynamics.

Local bonds recovered significant ground in the quarter following the spike in yields (moving prices lower) in March, as investors rushed to raise liquidity. The asset class benefitted from interest rate cuts from the South African Reserve Bank (SARB) during the quarter, one of 100 basis points in April and another of 50 basis points in May. SA government bonds continue to offer attractive real yields to investors, particularly given the current inflation backdrop.

Local listed property had a strong quarter following a difficult start to the year. It, however, remains the worst performing local asset class on a year-to-date basis, and continues to be plagued by the poor local economic environment and over supply in both the retail and office sectors.

Local cash provided a stable return for investors over the quarter; however, the asset class did place a drag on relative performance, largely due to strong returns from other local asset classes. With the recent moves from the SARB, yields on offer from local cash have decreased significantly since the start of the year.

Finance Minister Tito Mboweni delivered the supplementary budget towards the end of June, providing an update on the state of the country's finances along with government's intentions to reduce debt to a more sustainable level. While the content of the supplementary budget was generally well received, it was rather light on specific details, with many commentators highlighting the fact that implementation risk remains relatively high.

Overall, markets recovered significantly in the second quarter following a difficult start to the year. All local asset classes delivered strong returns and global equity markets also rebounded strongly from their lows in the first quarter. While we are pleased with the swift recovery, we would encourage investors to not get carried away by short term market movements. What is essential is for investors to focus on what they can control — saving more, reviewing financial goals, and keeping their sights focused on the long term.

For many, 2020 is certainly living up to its reputation as a year we'd rather forget—both in health and wealth—despite significant signs of financial improvement in the second quarter. Indeed, we have seen two of the more extraordinary periods an investor can face:

- The first quarter saw record falls, with share markets purportedly having their worst first quarter since the great depression in 1933.
- The second quarter saw one of the fastest market recoveries since at least 1983, notwithstanding that this mellowed in June as fears of a second wave of infection grew.

For most investors, the net result was a modestly negative year-to-date performance—but, peculiarly, this is no different than what one might expect in a typical six-monthly period.

Technology and “new economy” stocks continued to outperform as they thrived in the work-from-home environment. This contrasts with some long-established businesses, whose stocks are struggling despite decades of delivering positive cash flows for investors. The performance gap—embodied by growth and value stocks—has stretched to the bounds of extremity, which offers a contrarian opportunity, we believe.

Bond markets have moved strikingly too, with liquidity now moving freely and conditions largely settling. For example, we saw strong performance from riskier bond markets—as might be expected in such a speedy market recovery—with most of the earlier losses overturned. In fact, corporate bond yields are now back towards the record-lows of late 2019, especially among higher-rated issuance, which seemed unfathomable to some just months ago. These represent big rear-view moves that change the forward-looking landscape, with a dim assessment of prospective returns on offer.

Moreover, as the risk of a so-called second wave of coronavirus infection increases, the validity of the overall market rebound is being questioned. Indeed, we live in a challenging period, arguably with higher uncertainty than any period since World War II. For example, we have clear demand shocks to contend with—including everything from suppressed household spending to a lack of corporate investment. We have supply chain issues too, which would all be exacerbated if we saw another spike in coronavirus cases.

So, what lessons might we learn from this? Perhaps it is best to acknowledge three things; herd behaviour, policy response influence, and the opportunity to buy at low prices. The second quarter rebound highlighted the ever-important balance between return generation and risk management, reiterating why an investor can do well by staying emotionally grounded and smartly diversifying into attractively priced assets.

Where we go from here is the question everyone wants answered, but with rife uncertainty, we encourage investors to focus on what they can control—saving more, reviewing financial goals, and keeping our sights focused on the long term.

Southwood Balanced Portfolio Update

June 2020



Moderately aggressive investors will be pleased with returns generated in the second quarter of 2020. Local and global equity allocations both delivered strong returns as markets rebounded strongly from the Covid-19 induced sell off in March.

The Southwood Balanced Portfolio returned 15% for the quarter and has generated a return of 0,7% over the past year.

The Portfolio remains diversified in terms of its exposure to different asset classes and we remain confident in its ability to deliver inflation beating returns over the long-term independent of the market environment.

Asset Allocation

SA equity allocations, which make up the bulk of the Portfolio, contributed positively to performance, as the local equity market recovered significant ground following a difficult start to the year. The recovery was largely broad based; however, resources counters were the most significant driver of performance over the quarter, particularly gold and platinum counters. Naspers (+24%) was also a significant contributor to the performance of the SA equity market, given its large weight in the local equity indices. Offshore equity allocations also contributed positively to performance over the quarter, largely driven by strong performance from US equities and technology shares in particular. The rebound in global equity markets was largely broad based, with both developed and emerging equity markets rallying in the second quarter. Local bonds contributed significantly to performance during the second quarter as the local bond market recovered from the market slump in response to concerns around the spread of Covid-19 during March. Yields on SA government bonds fell significantly in the quarter (moving prices higher), assisted by reductions in the repo rate by the South African Reserve Bank (SARB) of 1.5%. Cash allocations in the Portfolio managed to deliver stable positive returns, however, these allocations did place a small drag on relative performance, largely due to the strong rebound in the performance of other local asset classes including bonds, equities and listed property. Yields on local cash allocations have fallen significantly since the start of the year, largely due to interest rate cuts from the SARB in response to the economic consequences of the Covid-19 pandemic as well as very well contained local inflation. Other offshore allocations, including cash and bonds, faced a headwind from a slightly stronger rand against major developed market currencies.

Fund Selection

All of the funds in the portfolio managed to deliver a positive return for the quarter.

CoreShares S&P SA Top 50 had a strong quarter, on the back of positive performance from large index constituents including Naspers (+24%), Anglo American PLC (+32%), BHP Group (+31%) and Richemont (+14%). Large cap shares had a very good quarter following the Covid-19 induced sell off in March, and managed to recover significant ground from the lows at the end of the first quarter. This fund invests in the largest 50 companies on the JSE by float-adjusted market capitalisation and provides investors with cheap exposure to the large cap and mid cap areas of the SA equity market.

Ninety One Global Franchise Feeder Fund underperformed its peers over the second quarter. This is as expected; the fund has a low market beta due to its investment style. The fund tends to protect in periods of turmoil (Q1), and lag in periods of strong market returns (Q2). The fund's positions in Healthcare (Johnson & Johnson and Roche) detracted as they lagged the market over the quarter.

The Nedgroup Core Bond Fund managed to deliver returns exceeding the bond index (10.6% compared to 9.94% for the index), this was due to the fund owning more long dated bonds than the index.

Regarding portfolio changes, we removed Ninety One Diversified Income and Fairtree Flexible Income Plus and introduced Coronation Strategic Income and Ninety One Global Franchise. We also increased our exposure to SA government bonds with the introduction of the Nedgroup Inv Core Bond fund. These changes by-large, align the portfolio to our latest and best thinking with regards to asset allocation and manager selection.

Summary

We are pleased that investors have been rewarded with strong returns after a difficult start to the year. Positive performance from allocations to both local and global growth assets drove performance during the quarter. The Portfolio continues to be allocated to a diverse range of attractively priced local and global asset classes and we are confident that it will be able to deliver on its objective over the long-term.

Morningstar Global Cautious Portfolio Update

June 2020



The portfolio gained 7.5% in the second quarter as most asset prices staged a strong recovery from the sharp falls witnessed at the end of the first quarter. Consequently, the portfolio delivered the equivalent of a couple of years of normal returns in three months. A consequence of this change in the investment environment is that asset prices are significantly less attractive than they were at the beginning of the quarter but remain more attractive than at the beginning of the year.

In the context of the large swings in asset prices, the year-to-date return of -0.3% appears unexciting and provides us with a reminder of the unpredictability of short-term market moves. In contrast the returns since inception remain 5.0% annualized. It is important to remember that given the relatively cautious nature of the portfolio, this return has been delivered with a modest risk profile.

Asset Allocation

Risk management is something we take seriously at all points of the cycle, but it has been especially important over the last six months. We entered the year somewhat cautiously positioned as we were concerned that most equity and corporate bond prices reflected a very rosy outlook and investors were vulnerable to disappointment. Equally we were concerned that government bonds would be less effective as an offset in the event of a fall in equity prices as yields were already unusually low.

As prices fell sharply, we took the opportunity to increase the equity exposure of the portfolio and so were well positioned as we entered the second quarter. During the quarter, we took advantage of the sharp rise in the additional yield investors receive for accepting corporate credit risk to add to the corporate bond positions.

While much changed over the quarter, investors preference for highly priced US technology and consumer focused companies has remained the same leading to a widening divergence in the price of these entities compared to companies in other sectors and countries. As long-term valuation-driven investors, we tend to find the best opportunities in those assets that are currently out of favour with other investors. This concentration of enthusiasm in a relatively narrow section of the market, provides lots of opportunities to find more attractively priced assets elsewhere. Examples would be UK and emerging market equities and investment grade corporate bonds. We are, therefore, sanguine about the long-term future returns embedded in this portfolio despite the recent rise in prices.

While equity prices have risen strongly, developed market government bonds remain near historically low yields. Consequently, the expected return from these assets remains very low and the probability that they will provide a safe haven in the event of a further fall in equity prices is reduced. We are, therefore, holding significantly fewer government bonds in the portfolio than normal.

Fund Selection

The asset exposure of the portfolio was the main driver of returns over the quarter with the equity holdings having a pronounced impact on returns in a period when all equity markets delivered a positive return. All of the fixed income holdings also managed to deliver positive returns. Turning to the underlying investments, fund selection was largely positive, with iShares North America Equity Index being the most significant contributor to performance and Franklin US Government Bond being the most significant detractor.

Taken together, we remain comfortable with the performance profile, especially on a risk-adjusted basis, delivering outcomes that balance against uncertainty and are in line with expectations.

Summary

Looking forward, we remain confident that the line-up will help us deliver positive outcomes. We continue to focus on risk-adjusted returns—not just returns—and have a constructive view on our ability to navigate different market pathways going forward. That is, we believe the portfolio is sensibly positioned (given what we can and can't know), with a selective yet diversified approach and ample cash to capture future opportunities.

Morningstar Global Balanced Portfolio Update

June 2020



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FINANCIAL PLANNING cc

The portfolio gained 11.7% in the second quarter as most asset prices staged a strong recovery from the sharp falls witnessed at the end of the first quarter. Consequently, the portfolio delivered the equivalent of several years of normal returns in three months. A consequence of this change in the investment environment is that asset prices are significantly less attractive than they were at the beginning of the quarter but remain more attractive than at the beginning of the year.

Taken together, we remain comfortable with the performance profile, especially on a risk-adjusted basis, delivering outcomes that balance against uncertainty and are in line with expectations.

Asset Allocation

Risk management is something we take seriously at all points of the cycle, but it has been especially important over the last six months. We entered the year somewhat cautiously positioned as we were concerned that most equity and corporate bond prices reflected a very rosy outlook and investors were vulnerable to disappointment. Equally we were concerned that government bonds would be less effective as an offset in the event of a fall in equity prices as yields were already unusually low.

As prices fell sharply, we took the opportunity to increase the equity exposure of the portfolio and so were well positioned as we entered the second quarter. During the quarter, we took advantage of the sharp rise in the additional yield investors receive for accepting corporate credit risk to add to the corporate bond positions.

While much changed over the quarter, investors preference for highly priced US technology and consumer focused companies has remained the same leading to a widening divergence in the price of these entities compared to companies in other sectors and countries. As long-term valuation-driven investors, we tend to find the best opportunities in those assets that are currently out of favour with other investors. This concentration of enthusiasm in a relatively narrow section of the market, provides lots of opportunities to find more attractively priced assets elsewhere. Examples would be UK and emerging market equities and investment grade corporate bonds. We are therefore sanguine about the long-term future returns embedded in this portfolio despite the recent rise in prices.

While equity prices have risen strongly, developed market government bonds remain near historically low yields. Consequently, the expected return from these assets remains very low and the probability that they will provide a safe haven in the event of a further fall in equity prices is reduced. We are therefore holding fewer government bonds in the portfolio than normal.

Fund Selection

The asset exposure of the portfolio was the main driver of returns over the quarter with the equity holdings having a pronounced impact on returns in a period when all equity markets delivered a positive return. All of the fixed income holdings also managed to deliver positive returns. Turning to the underlying investments, fund selection was largely positive, with Dodge and Cox Worldwide US Stock being the most significant contributor to performance and Franklin US Government Bond being the most significant detractor.

Summary

Looking forward, we remain confident that the line-up will help us deliver positive outcomes. We continue to focus on risk-adjusted returns—not just returns—and have a constructive view on our ability to navigate different market pathways going forward. That is, we believe the portfolio is sensibly positioned (given what we can and can't know), with a selective yet diversified approach to help investors reach their goals.

Morningstar Global Growth Portfolio Update

June 2020



The portfolio gained 17.1% in the second quarter as most asset prices staged a strong recovery from the sharp falls witnessed at the end of the first quarter. Consequently, the portfolio delivered the equivalent of several years of normal returns in three months. A consequence of this change in the investment environment is that asset prices are significantly less attractive than they were at the beginning of the quarter but remain more attractive than at the beginning of the year.

Taken together, we remain comfortable with the performance profile, especially on a risk-adjusted basis, delivering outcomes that balance against uncertainty and are in line with expectations.

Asset Allocation

Risk management is something we take seriously at all points of the cycle, but it has been especially important over the last six months. We entered the year somewhat cautiously positioned as we were concerned that most equity and corporate bond prices reflected a very rosy outlook and investors were vulnerable to disappointment. Equally we were concerned that government bonds would be less effective as an offset in the event of a fall in equity prices as yields were already unusually low. As prices fell sharply, we took the opportunity to increase the equity exposure of the portfolio and so were well positioned as we entered the second quarter.

While much changed over the quarter, investors preference for highly priced US technology and consumer focused companies has remained the same leading to a widening divergence in the price of these entities compared to companies in other sectors and countries. As long-term valuation-driven investors, we tend to find the best opportunities in those assets that are currently out of favour with other investors. This concentration of enthusiasm in a relatively narrow section of the market, provides lots of opportunities to find more attractively priced assets elsewhere. Examples would be UK and emerging market equities. We are therefore sanguine about the long-term future returns embedded in this portfolio despite the recent rise in prices.

Fund Selection

The asset exposure of the portfolio was the main driver of returns over the quarter with the equity holdings having a pronounced impact on returns in a period when all equity markets delivered a positive return. Turning to the underlying investments, fund selection was largely positive, with Franklin US Opportunities being the most significant contributor to performance and Ninety One UK Equity Alpha being the most significant detractor.

Summary

Looking forward, we remain confident that the line-up will help us deliver positive long-term outcomes. We continue to focus on risk-adjusted returns—not just returns—and have a constructive view on our ability to navigate different market pathways going forward. That is, we believe the portfolio is sensibly positioned (given what we can and can't know), with a selective yet diversified approach to help investors reach their goals.



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